



# Preliminary Views

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**June 3, 2013**

**Comments Due: September 30, 2013**

Preliminary Views  
of the Governmental Accounting Standards Board  
on major issues related to

## **Fair Value Measurement and Application**

**Project No. 26-5P**

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Governmental Accounting Standards Board

# FAIR VALUE MEASUREMENT AND APPLICATION

## Notice of Public Hearing and Request for Written Comments

**Public hearing.** A public hearing is scheduled on November 1, 2013, beginning at 8:30 a.m. at the Sheraton LaGuardia East Hotel, 135-20 39<sup>th</sup> Avenue, Flushing, New York. The hearing is being held in combination with the public hearing on the Exposure Draft of the proposed Concepts Statement, *Measurement of Elements of Financial Statements* (the proposed Concepts Statement). Interested individuals or organizations may participate in the public hearing in person or by telephone.

**Deadline for written notice of intent to participate in the public hearings:**  
September 30, 2013

## PUBLIC HEARING

**Basis for public hearing.** The GASB has scheduled the public hearing to obtain information from interested individuals and organizations about the issues discussed in this Preliminary Views and in the proposed Concepts Statement. The hearing will be conducted by one or more members of the Board and its staff. Interested parties are encouraged to participate at the hearing and through written response.

**Public hearing oral presentation requirements.** Individuals or organizations that want to make an oral presentation in person or by telephone at the public hearing are required to provide, **by the deadline for notice of intent to participate (September 30, 2013)**, a written notification of that intent and a copy of written comments addressing the issues discussed in this Preliminary Views. The notification and written submission should be addressed to the Director of Research and Technical Activities, Project No. 26-5P, and emailed to [director@gasb.org](mailto:director@gasb.org) or mailed to the address below. The notification should indicate a preference for participating in person or via telephone. The public hearing may be canceled if sufficient interest is not expressed by the deadline.

The Board intends to schedule all respondents who want to make oral presentations and will notify each individual or organization of the expected time of the presentation. The presentation may address issues discussed in this Preliminary Views, the proposed Concepts Statement, or both documents. The time allotted each individual or organization will be limited to about 30 minutes—10 minutes to summarize or elaborate on the written submissions, or to comment on the written submissions or presentations of others, and 20 minutes to respond to questions from those conducting the hearing.

**Observers.** Observers are welcome at the public hearing and are urged to submit written comments.

## WRITTEN COMMENTS

**Deadline for submitting written comments:** September 30, 2013

**Requirements for written comments.** Any individual or organization that wants to provide written comments but does not intend to participate in the public hearing should provide those comments by **September 30, 2013**. Comments should be addressed to the Director of Research and Technical Activities, Project No. 26-5P, and emailed to [director@gasb.org](mailto:director@gasb.org) or mailed to the address below.

## OTHER INFORMATION

**Public files.** Written comments and transcripts of the public hearing will become part of the Board's public file and will be available for inspection at the Board's offices. Written comments also are posted on the GASB's website. Copies of the transcripts may be obtained for a specified charge.

**Orders.** This Preliminary Views also may be downloaded from the GASB's website at [www.gasb.org](http://www.gasb.org). Any individual or organization may obtain one printed copy of this Preliminary Views on request without charge until September 30, 2013, by writing or phoning the GASB Order Department. For information on prices for additional copies and copies requested after that date, please contact the Order Department at the following address:

Governmental Accounting Standards Board  
401 Merritt 7  
PO Box 5116  
Norwalk, CT 06856-5116

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Preliminary Views  
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## **Fair Value Measurement and Application**

Project No. 26-5P



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## **Notice to Recipients of This Preliminary Views**

The Governmental Accounting Standards Board (GASB) is responsible for developing standards of state and local governmental accounting and financial reporting that will (1) result in useful information for users of financial reports and (2) guide and educate the public, including issuers, auditors, and users of those financial reports.

The due process procedures that we follow before issuing our standards are designed to encourage broad public participation in the standards-setting process. As part of that due process, the GASB is issuing this Preliminary Views to solicit comments on the Board's proposals on fair value measurement and application. This Preliminary Views identifies significant issues that are known to exist and invites respondents to comment on them and identify additional relevant issues. This Preliminary Views seeks feedback on issues associated with fair value measurement and application with related disclosures.

This Preliminary Views is a step toward an Exposure Draft of a Statement of Governmental Accounting Standards but is *not* an Exposure Draft. A Preliminary Views is a Board document designed to set forth and seek comments on the Board's current views at a relatively early stage of a project. This document presents the Board's preliminary views on fair value measurement and application and related disclosure and discusses the concepts, purposes, and objectives of the Board's proposal. A Preliminary Views generally is issued when the Board anticipates that respondents are likely to be sharply divided on the issues or when the Board itself is sharply divided on the issues. The Board anticipates that respondents likely will express a range of differing views on major issues related to the measurement and application of fair value to assets and liabilities, including related note disclosures and, therefore, it believes that a Preliminary Views, rather than an Exposure Draft, is appropriate. Although some Board members may disagree with certain aspects of the Preliminary Views and some may feel more strongly about certain provisions than others do, this Preliminary Views represents the Board's current views on the issues discussed in this document.

We invite your comments on all matters in this Preliminary Views, especially those addressed in the questions on the following page. Respondents are requested to give their views only after reading the entire text of this Preliminary Views and all of the questions. Because guidance proposed in this Preliminary Views may be modified before it is issued as an Exposure Draft, it is important that you comment on any aspects with which you agree, as well as any with which you disagree. To facilitate our analysis of the response to this Preliminary Views, it would be helpful if you explain the reasons for your views, including alternatives that you believe we should consider.

All responses are distributed to the Board and to staff members assigned to this project, and all comments are considered during deliberations leading to a final Statement. Only after the Board is satisfied that all alternatives have adequately been considered, and modifications have been made as appropriate, will a vote be taken to issue an Exposure Draft. The Board also will seek and consider comments on any future due process documents before proceeding to a final Statement.

## **QUESTIONS FOR RESPONDENTS**

### **Issue 1—Definition of Fair Value**

1. It is the Board’s preliminary view that the definition of fair value should be the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See Chapter 2, paragraphs 3–6.) Do you agree with this view? Why or why not?

### **Issue 2—Transaction Costs**

2. It is the Board’s preliminary view that transaction costs to sell an investment should be treated as period costs. That is, transaction costs would not be a reduction of an investment’s fair value in the statement of financial position. Transaction costs would be reported as expenses or expenditures in the period an investment is sold. (See Chapter 2, paragraphs 21 and 22.) Do you agree with this view? Why or why not?

### **Issue 3—Definition of an Investment**

3. It is the Board’s preliminary view that the definition of an investment should be a security or other asset that a government holds primarily for the purpose of income or profit, and its present service capacity is based solely on its ability to generate cash, to be sold to generate cash, or to procure services for the citizenry. (See Chapter 3, paragraphs 2–4.) Do you agree with this view? Why or why not?

### **Issue 4—Measurement of Investments**

4. It is the Board’s preliminary view that investments generally should be measured at fair value on a recurring basis. (See Chapter 3, paragraphs 14–16.) Unless specifically excluded from a fair value measurement, investments would no longer be valued using amortized cost or other measures. (See Chapter 3, paragraph 19.) Do you agree with this view? Why or why not?

### **Issue 5—Disclosures**

- 5a. It is the Board’s preliminary view that the disclosures discussed in Chapter 4 should be required. Are any of the proposed disclosures not essential to a financial statement user’s understanding of financial position or inflows and outflows of resources? Why or why not?
- 5b. What other disclosures related to fair value should the Board consider? Why?

## Summary

This document presents the preliminary views of the Governmental Accounting Standards Board on the issues associated with measurement and application of fair value and related disclosures. The Board believes that if these views were to be incorporated into a final Statement, the accounting and financial reporting guidance on fair value measurements would be more complete and understandable to practitioners and would result in more useful information for financial statement users.

It is the Board's preliminary view that the fair value of an asset or liability should be defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The objective of a fair value measurement would be to estimate the exit price of assets and liabilities using observable or unobservable inputs. This document contains the Board's preliminary views regarding the definition of fair value, methods used to measure fair value, and the application of fair value measurements to elements of financial statements, including disclosures related to fair value.

### Fair Value Measurements

In determining an appropriate fair value measurement, the characteristics of the asset or liability would be taken into account, such as the condition and location of an asset. Markets also would be considered. In a fair value measurement, the sale of an asset or the transfer of a liability would be expected to take place in the principal market or, in the absence of a principal market, in the most advantageous market to which a government has access. The Board believes that transaction costs, such as commissions, do not meet the definition of an asset and, therefore, should be recognized when incurred.

Certain market conditions may make quoted prices less reliable for fair value measurement. If fair value measurement is required and there has been a significant decrease in the volume or level of activity for an asset or liability in relation to normal market activity for the asset or liability (or similar assets or liabilities), further analysis of the transactions or quoted prices would be needed. Similarly, if evidence indicates that a transaction is not orderly, a government would place little, if any, weight (compared with other indications of fair value) on that transaction price.

It is the Board's preliminary view that valuation techniques used to estimate the fair value of an asset or liability should be appropriate in the circumstances. The objective of using a valuation technique would be to estimate the price at which an orderly sale of an asset or transfer of a liability would take place between market participants, at the measurement date, under current market conditions. Valuation techniques would maximize the use of observable inputs and minimize the use of unobservable inputs. Selected inputs would be consistent with the characteristics of the asset or liability that market participants would take into account in a transaction for the asset or liability.

Valuation approaches would include market, cost, and income approaches. The market approach would use prices and other relevant information generated by market transactions involving identical or similar assets, liabilities, or a group of assets and liabilities. The cost approach would reflect the amount that would be required currently to replace the service capacity of an asset. The income approach would convert future

amounts (for example, cash flows or income and expenses) to a single discounted amount. When the income approach is used, the fair value measurement would reflect current market expectations about those future amounts.

To increase consistency and comparability in fair value measurements and related disclosures, it is the Board's preliminary view that a fair value hierarchy should be established that would categorize the inputs to valuation techniques used to measure fair value into three levels (Level 1, 2, or 3). The highest priority would be given to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). Level 2 inputs would be other than quoted prices that are observable for the asset or liability, either directly or indirectly. Quoted prices obtained from third parties, such as pricing services or brokers, would be allowed if a government has determined that the quoted prices provided by those parties are developed in accordance with the preliminary views described in this document.

If fair value measurements were applied to nonfinancial assets, those assets would be valued based on their highest and best use, which would take into account the best use of the asset that is physically possible, legally permissible, and financially feasible.

A government would be permitted, as a practical expedient, to estimate the fair value of an investment that does not have a readily determinable fair value using the net asset value per share (or its equivalent) of the investment. This expedient would be available if the net asset value per share of the investment (or its equivalent) is calculated in a manner consistent with the measurement principles for investment companies as of the government's measurement date.

Fair value also may apply to certain liabilities. An example is an interest rate swap that is in a liability position to a government. The fair value of such a liability would be the price to transfer it to a market participant at the measurement date. The liability would be assumed to remain outstanding, requiring the assuming market participant to fulfill the obligation. Additionally, the fair value measurement would take into account the effect of nonperformance risk, which includes a government's own credit risk and any other factors that might influence the likelihood that the obligation would or would not be fulfilled.

## **Application of Fair Value to Assets and Liabilities**

It is the Board's preliminary view that investments generally should be measured at fair value. That view suggests that the definition of an investment is a significant issue. The Board's preliminary view is that an investment should be defined as a security or other asset that a government holds primarily for the purpose of income or profit, and the present service capacity of which is based solely on its ability to generate cash, to be sold to generate cash, or to procure services for the citizenry.

Certain investments would be excluded from measurement at fair value and would continue to be measured according to existing GASB literature. This would include investments in 2a7-like external investment pools, investments in money market instruments with remaining maturity at time of purchase of one year or less, investments in certain life insurance policies, investments in common stock that are eligible for the equity method, and investments in nonparticipating interest-earning investment contracts.

Finally, it is the Board's preliminary view that the measurement requirements for donated capital assets should be revised. Donated capital assets currently measured at fair

value would be measured using acquisition value. Acquisition value would represent the price that would be paid for acquiring similar assets having similar service capacity as of the acquisition date. Likewise, acquisition value would replace fair value measurements for donated works of art, historical treasures, and similar assets; capital assets received in a service concession arrangement; and nonmonetary assets acquired in an exchange when the value of the asset received is used to measure the cost of the asset acquired.

## **Disclosures**

This Preliminary Views addresses fair value disclosures in the notes to the financial statements, including the required level of detail. The Board believes the following disclosures would be essential to understanding the financial position of a government:

- For recurring and nonrecurring fair value measurements:
  - The fair value measurement at the end of the reporting period
  - The level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (Level 1, 2, or 3)
  - A description of the valuation techniques and the inputs used in the fair value measurement
- For recurring fair value measurements within Level 3 only, a narrative description of the sensitivity of fair value measurements to changes in unobservable inputs
- For nonrecurring fair value measurements, the reasons for the measurement
- For investments in entities that calculate a net asset value per share or its equivalent, information that helps users understand the nature and risks of the investments and whether the investments are likely to be sold at amounts different from net asset value per share.

## **How the Changes Proposed in This Preliminary Views Would Improve Financial Reporting**

The application of the Board's proposed requirements in this Preliminary Views, if ultimately issued as a Statement, would enhance financial statement users' ability to assess the government's accountability and provide more decision-useful information. Additional disclosures would provide financial statement users with relevant information about the assumptions upon which fair value estimates are based. Consistency of reporting would be enhanced by extension of fair value measurements to most investments regardless of the type of government holding those investments. Financial statement preparers, auditors, and those in the finance community would have more complete guidance as to how estimates of fair value should be developed and the relative significance of disparate fair value information.

## CHAPTER 1—OBJECTIVES, SCOPE, AND BACKGROUND

### Objectives of the Fair Value Measurement and Application Project

1. The objectives of the Fair Value Measurement and Application project are to reexamine the definition of **fair value**,<sup>1</sup> establish the methods used to measure fair value, and provide guidance for the application of fair value measurements to elements of financial statements, including disclosures related to fair value.

### Project Scope

2. This project addresses assets and liabilities already measured at fair value and **investments** that previously have not been measured at fair value. The Board's preliminary views on these topics are presented in this document.

### Project Background

3. The Board first applied fair value to investments in Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, which provided for recognition of fair value measurements and fair value gains and losses of most pension plan investments. That Statement was issued in 1994 and included limited application guidance. A definition of fair value was provided, and fair value was explained in the context of market-observed prices and expected cash flows. Fair value measurements were extended in 1997 to governmental entities other than pension plans in Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*. Statement 31 also required disclosures related to fair value in the notes to the financial statements. Most investments that governments hold—including debt securities, certificates of deposit, and positions in external investment pools—were affected by Statement 31. Some investments, however, were not affected, such as some investments in real estate, alternative investments held by general-purpose governments, and non-exchange-traded equity securities. Lastly, some **financial instruments**, such as loans, bear interest, prompting questions as to whether positions in such instruments would be considered debt investments, and hence measured at fair value, or loan receivables, which are measured at amortized cost. In Statement No. 32, *Accounting and Financial Reporting for Internal Revenue Code Section 457 Deferred Compensation Plans*, issued in 1997, the Board applied fair value measurements to investments held by Internal Revenue Code Section 457 deferred compensation plans.

4. In 2004, the Board incorporated the fair value guidance used for pensions into Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*. In Statement No. 52, *Land and Other Real Estate Held as Investments by Endowments*, issued in 2007, the Board addressed investments in land held by endowments, indicating that such investments should be measured at fair value. In

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<sup>1</sup>Terms defined in the Glossary are shown in **boldface type** the first time they appear in this Preliminary Views.

Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, issued in 2008, the Board required that derivative instruments be measured at fair value. Finally, the Board again required that most pension plan investments be measured at fair value when it issued Statement No. 67, *Financial Reporting for Pension Plans*, in 2012.

5. During this time, the Financial Accounting Standards Board (FASB) also issued standards focusing on fair value measurements. GASB Statements 25 and 31 considered the contemporaneous FASB literature. FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, issued in 1991, was the source of the definition of fair value used in GASB Statements 25 and 31. FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, issued in 1993, extended fair value measurements of investment securities to recognition in the balance sheets of private-sector organizations. However, in corporate financial statements, recognition of fair value changes depends on whether the investment securities are held for sale, trading, or held-to-maturity. For not-for-profit organizations, fair value measurements were required by FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, issued in 1995.

6. One of the more relevant FASB standards in this area is Statement No. 157, *Fair Value Measurements*, which was issued in 2006 and subsequently amended many times. Statement 157 is the basis for the current FASB literature on fair value measurement and disclosure and is codified in Topic 820 of the *FASB Accounting Standards Codification*.<sup>®</sup>

7. In April 2008, the Fair Value Measurement and Application project was added to the GASB's research agenda. Much of the focus of the Board during this time was on monitoring developments in the accounting standards issued by the FASB and the International Accounting Standards Board. The fair value research at that time also was informed by the project staff addressing implementation issues associated with Statement 53.

## **Survey of Financial Statement Preparers**

8. In 2010, the GASB conducted a survey of financial statement preparers. The objective of the survey was to gain information regarding fair value measurement and its application. At that time, the findings of the survey were used to assist the Board in determining whether to proceed with this project. Sixty preparers responded to the survey. The sample taken for this survey was not intended to be statistically valid.

9. Participants were provided with a list of assets and liabilities measured at fair value under existing GASB standards. In addition, participants were provided with a list of assets measured at fair value on a nonrecurring basis. Participants were asked to provide (a) a listing of their organization's types of investments, other assets, and liabilities measured at fair value and (b) how much it would cost to remeasure the fair value for all assets and liabilities reported at fair value in terms of staff hours, dollars, or both. Finally, the survey posed specific questions related to fair value measurement.

10. Concerning the **valuation techniques** currently used in practice, respondents indicated that fair value measurements were generally based on (a) market prices, such as dealer quotes and exchange prices; (b) pricing services, including appraisals; and (c) discounted cash flows.

11. Respondents indicated that fair value estimates may require gathering information from a number of sources and applying professional judgment. The survey asked respondents to describe (a) methods used to determine fair values and (b) any issues encountered in developing fair values for financial reporting purposes. Respondents provided a wide variety of responses with respect to methods used to determine fair value. Several respondents indicated difficulties in determining fair value for real estate, including land, and uncertainties surrounding alternative investments.

12. Respondents generally indicated that most of their investments were measured at fair value. Investment types ranged from U.S. Treasuries and agency securities to private equities, derivative instruments, and investment pools. The survey asked respondents to provide the types of investments reported by their government, if any, that were *not* measured at fair value and the basis upon which they were measured. Some respondents indicated that some assets that may be considered investments were not carried at fair value. The most common types of assets not measured at fair value were real estate, private equities, guaranteed investment contracts, overnight repurchase agreements, mineral interests, and farm loans, all generally measured at cost.

13. Respondents were asked to comment on the foreseeable issues if these types of investments that were identified by the governments were to be measured at fair value. Cost and time were cited as issues. In addition, the availability of information also was identified.

## **Survey of Financial Statement Users**

14. In 2011, the GASB conducted a survey of financial statement users. The focus of the survey was on the usefulness of fair value information to users and whether they were receiving the fair value information they needed. Forty-three responses were received. Again, the sample taken for this survey was not intended to be statistically valid. Responses indicated a general reliance on fair value information to assess the financial condition of the government, to determine creditworthiness, and to evaluate debt ratings.

15. Respondents also provided feedback on the value of fair value information presented in note disclosures. Respondents indicated that disclosures about fair value and the changes in fair value assisted in assessing the following:

- a. *General financial position of a government.* Determining stewardship and a potential impact on net position, buy/sell decisions, trends and overall asset or liability positions, and general modeling and budgeting.
- b. *Condition of investments.* Evaluating investment maturity terms, assessing the financial strength of pension or treasury assets, and considering the diversity of investments.

- c. *Credit risk and liquidity of a government.* Evaluating a government's liquidity (such as liquidity ratios and cash-flow stability); appraising credit worthiness; assessing debt ratings; evaluating economic status, current financial condition, and profitability; assessing exposure to financial and commodity agreements; and measuring risk profiles.
- d. *Use of derivative instruments.* Evaluating a government's use of derivative instruments, such as interest rate swaps, focusing on a government's exposure to counterparty risk and testing results of termination triggers.
- e. *Pension obligations.* Evaluating a government's retirement obligation-related assets, pension assets and liabilities, and the funded status of pensions.
- f. *Basis of fair value estimates.* Evaluating a government's determination of fair values, which considers the credibility of asset valuations and the underlying assumptions.
- g. *Specific interests described in the survey.* Determining a government's compliance with fair-value-based bond covenants, commitments, contingencies, and some fair-value-based property values.

16. Financial statement users were asked about the reliability of the **inputs** from which fair value prices were derived, either market-based or calculated prices. The survey explained that calculated prices were based on management's assessments using formulas, models, or appraisals. Many participants responding rated understanding how prices are derived (either from market-based information or calculated by management) as either very important or important.

## **Current Agenda Project**

17. Based on the research findings, a project prospectus was discussed with the Governmental Accounting Standards Advisory Committee (GASAC) members in October 2010, and again in March 2011. Based on the GASAC feedback and the perceived need for additional guidance in this area, the project was moved to the Board's current agenda in August 2011 and deliberations began in October 2011.

18. A task force composed of eleven persons broadly representative of the GASB's constituency was appointed in 2011. The task force members reviewed and commented on papers describing the issues discussed by the Board and included in this Preliminary Views, including illustrative disclosure examples. In addition, further feedback was sought from GASAC members at their meetings.

## **Relationship to Proposed Concepts Statement**

19. This Preliminary Views is consistent with the concepts presented in the Board's Exposure Draft of a Concepts Statement, *Measurement of Elements of Financial Statements*. Both measurement approaches and measurement attributes are addressed in that document. A measurement approach determines whether an asset or liability presented in a financial statement should be (a) reported at an amount that reflects the value at the date when the asset was acquired or the liability incurred or (b) remeasured and reported at an amount that reflects the value at the date of the financial statements. A

measurement attribute is the feature or characteristic of the asset or liability that is measured.

20. Fair value is identified in the proposed Concepts Statement as a measurement attribute that would be defined and further described as follows. [Bold text added.]

### **Fair Value**

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an **orderly transaction** between **market participants** at the measurement date. As such, fair value is an **exit price**. The market to which the definition of fair value refers is the **principal market** for the asset or liability or, when there is not a principal market, the entity's **most advantageous market**. For nonfinancial assets, the price should represent the value of the asset at its **highest and best use** as determined by market participants. The highest and best use notion takes into account uses that are physically possible, legally permissible, and financially feasible. For liabilities, the price should take into consideration the credit standing of the entity. Multiple valuation techniques may be used to measure fair value.

Fair value is suitable for use either as an initial amount or as a remeasurement amount. Fair value could be applied as an initial amount in circumstances in which a historical cost amount is not available, typically because the asset or liability did not arise from an exchange transaction or because the asset or liability was acquired in a group without amounts assigned to the individual assets and liabilities in the group. Relevance of the use of fair value to presenting information that promotes the objectives of financial reporting is tied to (a) whether it is applied as an initial amount or a remeasured amount and (b) the nature of the asset or liability being measured. The extent to which a fair value is understandable, reliable, and timely depends upon the methods and inputs used to measure fair value. Comparability of information in a statement of financial position is improved when fair value is used as a remeasured amount. Fair value generally is not suitable for assets that will be used directly to provide services because fair value is an exit price and governments will not be selling or otherwise exiting from these assets. [paragraphs 35 and 36]

## CHAPTER 2—FAIR VALUE MEASUREMENTS

1. This chapter describes general principles that the Board believes should be employed in fair value measurements. A proposed definition of fair value and the notions that underpin that definition are described. Additionally, how fair value meets the qualitative characteristics of information in financial reporting is discussed. Finally, approaches to valuation—market, cost, and income—are presented. Valuation techniques consistent with those approaches would include inputs organized into a hierarchy with three levels.

2. The Board believes that while the GASB and other standards setters may vary in their requirements for when fair value measurements are applied in the financial statements, stakeholders and financial markets would benefit if the GASB's definition of fair value is consistent with other standards setters. In other words, fair value measurements should be consistent among standards setters, even though the specific assets and liabilities that are measured at fair value may vary.

### Definition of Fair Value

3. **It is the Board's preliminary view that fair value should be defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.** The Board believes that fair value is a market-based measurement, not an entity- or government-specific measurement. This revised definition would emphasize that a fair value measure is made at the measurement date, whereas the earlier definition only referred to a current transaction. Markets are further emphasized through the replacement of willing parties with market participants.

4. The definition of fair value in this Preliminary Views retains the exchange price notion contained in the GASB's current definition of fair value. This revised definition, however, would clarify that the exchange price is the price in an orderly transaction between market participants to sell an asset or transfer a liability in the principal (or most advantageous) market for the asset or liability. The Board believes that the sale of an asset or the transfer of a liability should be an orderly transaction, not a forced transaction. (See Chapter 2, paragraph 25.) It would be assumed that information pertaining to an orderly transaction would be available to market participants for a sufficiently long period prior to the measurement date to help ensure that the asset or liability would be sold or transferred at the most advantageous price.

5. The sale of an asset or the transfer of a liability would be a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability. Therefore, the objective of a fair value measurement would be to determine the price that would be received for the asset or paid to transfer the liability at the measurement date—that is, an exit price.

6. The Board concluded that an exit price would be appropriate because it embodies current expectations about the future inflows of resources associated with the asset and the

future outflows of resources associated with the liability from the perspective of market participants. The emphasis on inflows and outflows of resources would be consistent with the definitions of assets and liabilities in Concepts Statement No. 4, *Elements of Financial Statements*. In that Concepts Statement, paragraph 8 defines *assets* as “resources with present service capacity that the government presently controls,” and paragraph 17 defines *liabilities* as “present obligations to sacrifice resources that the government has little or no discretion to avoid.”

## **Fair Value and the Qualitative Characteristics of Information in Financial Reporting**

7. The qualitative characteristics of information in financial reporting are described in Concepts Statement No. 1, *Objectives of Financial Reporting* (paragraphs 62–68). These characteristics are understandability, reliability, relevance, timeliness, consistency, and comparability. **It is the Board’s preliminary view that fair value information meets the qualitative characteristics of financial information.**

### **Understandability**

8. The understandability characteristic recognizes that users of financial information have varying knowledge about financial reporting, and that information should be presented as simply as possible. Information, however, should not be excluded merely because it is difficult to understand. The application of fair value requires remeasurement of assets and liabilities. While remeasurement may be less understandable compared to cost-based measurements, the Board believes that reporting fair value gains and losses in certain cases promotes assessment of interperiod equity. Further, the Board believes that fair value measurements may provide a better understanding of the activities during a reporting period. Fair value measurements often involve judgment, but with effective disclosure of the factors used in making those judgments, this characteristic could be met.

### **Reliability**

9. Reliability means that a fair value measurement faithfully represents what it purports to represent. Reliability also speaks to verifiability and freedom from bias. The present service capacity of an investment asset is its ability to generate cash, to be sold to generate cash, or to procure services (Concepts Statement 4, paragraph 9). Verifiability would be enhanced when fair value measurements are based on market-observed prices. As with other accounting estimates, fair value measurements often would require professional judgment. This would be the case, for example, when markets are inactive or a fair value estimate could not be made based on market-observed prices. Disclosures would be necessary to describe the basis for fair value estimates and to provide unbiased information. In the Board’s view, such circumstances should not preclude the application of fair value measurements.

## **Relevance**

10. Relevance means there is a close logical relationship between the information provided and the purpose for which it is needed. The Board's research indicates that financial statement users are interested in analyzing the amount, timing, and uncertainty of future net cash inflows to a government. Because fair value depicts expected future cash flows, the Board believes that fair value would be a relevant measure of an investment asset's ability to help a government provide services. Periodic information about the fair value of a government's investment assets is intended to help users in making their own assessments and in confirming or correcting their earlier expectations. Fair value measurements would provide users with information to help them assess a government's accountability, the level of services that it could provide, and the government's financial position and economic condition—thereby helping to achieve this qualitative characteristic.

## **Timeliness**

11. In order to be useful, financial reports should be issued soon enough after the occurrence of reported events to affect decisions. The Board recognizes that obtaining fair value information for use in preparation of the financial statements (including disclosures) may take more time than other measurements (such as historical cost). However, the Board believes that delays in financial reports generally should not be significant enough to outweigh the usefulness of fair value information.

## **Consistency**

12. Financial reports should apply accounting principles consistently for similar transactions and events. Governments continually decide whether to buy, sell, or hold investment assets. The Board believes that information about the fair values of investment assets enables investors, creditors, and other users to assess the consequences of a government's investment strategies. Information about fair value would permit continuous reassessment of earlier decisions in light of current circumstances. Movements in fair value during the period that an investment asset is held would provide a benchmark with which to assess the results of a government's decisions and to assess its ability to continue to meet obligations and provide services.

## **Comparability**

13. Comparability means that users should be able to make comparisons among governments. The Board believes that the ability to meaningfully evaluate a government's investment performance—to compare its returns, adjusted for risk, to those of common market indicators or to other entities—is enhanced when investments are reported at fair value. The economic benefit that investments provide to a government comes from an investment's ability to generate income that supports a government's activities. Cash flows from investments do not depend on the government that owns the investments or the amount for which a government acquired them; thus, the measurement of investments should not vary significantly among governments.

## **The Asset or Liability**

14. The Board believes that a fair value measurement, although market-based, should be for a particular asset or liability. Therefore, when measuring the fair value of the asset or liability, the government making the measurement would consider the characteristics of that asset or liability as market participants would.

15. The Board believes that a government should consider the **unit of account** at which the fair value measurement is made. The unit of account refers to the level at which an asset or a liability is aggregated or disaggregated as provided by an accounting standard. For example, multiple investments may be held in one brokerage account but the unit of account (for which fair value would be determined) would be each individual security, rather than the account as a whole.

## **The Transaction—The Principal (or Most Advantageous) Market**

16. The Board believes that a fair value measurement assumes that a hypothetical transaction takes place in markets to which a government has access: either the principal market for that asset or liability or the most advantageous market (if there is no principal market). The Board believes the principal market for an asset or liability is the market with the greatest volume and level of activity for that asset or liability. A government need not undertake an exhaustive search of all possible markets to identify the principal market or, in the absence of a principal market, the most advantageous market; however, it would take into account all information that is reasonably available. In the absence of evidence to the contrary, the market in which the government normally would enter into a transaction to sell the asset or transfer the liability would be presumed to be the principal market or, in the absence of a principal market, the most advantageous market.

17. The Board believes the most advantageous market is the market in which the government would sell the asset or transfer the liability with the price that maximizes the amount that would be received for the asset or minimizes the amount that would be paid to transfer the liability. **Transaction costs** would be considered in determining the most advantageous market.

18. The sale of an asset or transfer of a liability would be most likely to occur in the principal market and, therefore, the price occurring in that market would be the most appropriate measure of the exit price a government would receive or pay. Likewise, the most advantageous market is the one in which a government would be most likely to transact in the absence of a principal market.

## **Market Participants**

19. The Board believes it is important to emphasize that a fair value measurement is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement would be determined based on the assumptions that market participants—buyers and sellers in the principal (or most advantageous) market for the asset or liability—would use in pricing the asset or liability. A fair value measurement also

assumes that the market participants act in their own economic best interest and seek to maximize the fair value of a financial or nonfinancial asset or minimize the fair value of a liability.

20. To convey more clearly the idea of fair value measurements from the perspective of market participants, this Preliminary Views replaces the term *willing parties* used in the current fair value definition with *market participants*. This term refers to buyers and sellers in the principal (or most advantageous) market for the asset or liability that are independent of the reporting entity, knowledgeable, and both able and willing to transact.

### **The Price—Transaction Costs**

21. The Board believes that the price used in a fair value measurement should not be adjusted for transaction costs. Transaction costs are incremental direct costs incurred to effect a transaction, such as transaction fees and brokerage commissions. Transaction costs do not meet the definition of an asset or deferred outflow of resources and, therefore, would be reported as an expenditure or expense in the period incurred. Such costs are specific to each transaction. These costs can vary from government to government; therefore, they are entity-specific rather than market-based. While transaction costs would be considered to determine the most advantageous market, as previously described, they would not be considered in the actual fair value measurement.

22. The measurement approach taken for investments in pension and other postemployment benefit plans currently requires that fair value be adjusted for transaction costs. This approach is inconsistent with the Board's preliminary view of fair value being a market-based exit price. How the Board's proposal would affect current practice is discussed in Chapter 3, paragraphs 25 and 26.

### **Measuring Fair Value When the Volume or Level of Activity for an Asset or a Liability Has Significantly Decreased**

23. The Board believes that an **active market** is best for producing prices that are most indicative of fair value. Therefore, if the market activity for a certain asset or liability has significantly decreased, the Board believes that a government should consider whether the resultant transaction prices are the best reflection of fair value. Those prices may need to be adjusted, or another valuation method may need to be employed.

24. The Board believes that the fair value of an asset or liability may be affected when there is a significant decrease in the volume or level of activity for that asset or liability in relation to its normal market activity. If a government's evaluation of factors confirms this occurrence, further analysis of the transactions or quoted prices would be necessary. If the government then determines that a transaction or quoted price does not represent fair value, an adjustment would be necessary if the government uses the price as a basis for measuring fair value. That adjustment may be significant to the fair value measurement in its entirety. A change in valuation technique also may be appropriate in these circumstances.

## Identifying Transactions That Are Not Orderly

25. The Board's proposed definition of fair value is based on an orderly transaction. The Board acknowledges that not all transactions are orderly. Indicators that transactions are not orderly include:

- a. There was not adequate exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities under current market conditions.
- b. There was a usual and customary marketing period but the seller marketed the asset or liability to a single market participant.
- c. The seller was in or near bankruptcy.
- d. The seller was required to sell to meet regulatory or legal requirements.
- e. The transaction price was an outlier when compared with other recent transactions for the same or a similar asset or liability.

26. Governments would consider readily available information as to whether transactions used in fair value measurements are orderly. The Board believes this consideration should be necessary, because reliance on nonorderly transactions in the measurement of fair value could result in a significantly different amount than if prices from orderly transactions were considered.

27. If there has been a significant decrease in the volume or level of activity for an asset or liability in relation to its normal market activity, determining whether a transaction is orderly would be more difficult. Thus, a government would evaluate the circumstances to determine whether, on the weight of the evidence available, the transaction is orderly. While a government would not need to undertake exhaustive efforts to determine whether a transaction is orderly, it would not ignore information that is reasonably available. A government would be presumed to have sufficient information to determine whether a transaction is orderly if it is a party to the transaction.

## Valuation Approaches and Techniques

28. **It is the preliminary view of the Board that valuation approaches and techniques used to measure fair value should be appropriate in the circumstances and should maximize the use of relevant observable inputs.** The term *inputs* refers to the assumptions that market participants would use in pricing an asset or a liability. The objective of a **valuation approach** would be to estimate the price at which an orderly transaction to sell an asset or to transfer a liability would take place between market participants at the measurement date under current market conditions. If market information that qualifies as a Level 1 input (see below) is available for measuring fair value, a government would employ the market approach rather than the cost or income approach. Valuation techniques would be applied consistently from period to period for a given asset or liability. A change in valuation techniques would be permitted, provided that the change results in a measurement that would be equally or more representative of fair value in the circumstances. Such a change would be treated as a change in accounting

estimate. The Board believes that the valuation technique chosen should be consistent with the three approaches described in the following paragraphs—market, cost, or income.

### **Market Approach**

29. The **market approach** would use prices and other relevant information generated by market transactions involving identical or comparable assets and liabilities. The use of a quoted price from an active market is a technique that is consistent with the market approach. Another valuation technique consistent with the market approach would be **matrix pricing**. Matrix pricing is a mathematical technique used principally to value some types of financial instruments, such as debt securities, without relying exclusively on quoted prices for the specific securities. Rather, matrix pricing relies on the securities' relationship to other benchmark quoted securities.

### **Cost Approach**

30. The **cost approach** would be derived from the amount that would be required currently to replace the service capacity of an asset. When considering a market transaction, the amount received by the seller (its exit price) would be the same as the amount paid by the buyer (its **entry price**). The value to the buyer of the service capacity of the asset would be the amount at which the transaction would occur.

### **Income Approach**

31. The **income approach** would convert future amounts (for example, projected cash flows) to a single current (that is, discounted) amount. One valuation technique identified with the income approach would be the calculation of the **present value** of expected future cash flows. Other techniques under the income approach include **option pricing models**, the **multi-period excess earnings method**, and the **relief from royalty method**.

### **Blockage Factor**

32. The Board does not believe that a blockage factor—a premium or discount for the size of a government's holding of an asset—should be an input in pricing an asset. It is a characteristic of the government's position in holding an asset rather than a characteristic of the asset itself.

### **Inputs Based on Bid and Ask Prices**

33. A bid price represents the price a purchaser is willing to pay; an ask price represents the price at which a seller is willing to sell. The price most representative of fair value would be used to measure fair value regardless of where the input is categorized within the fair value hierarchy. (See discussion of the hierarchy and levels below.) When no price would be more representative than another, the Board believes the use of a bid price for an asset and an ask price for a liability should be permitted but not required. The use of bid and ask prices in such circumstances would be justified because these are the prices that assure that an asset could be sold or a liability transferred. The optional use of

mid-market pricing or other pricing conventions may provide a practical expedient that could assist in the application of fair value.

## **Fair Value Hierarchy of Inputs**

34. **It is the Board's preliminary view that assets and liabilities measured at fair value should be organized into a hierarchy based on the levels of inputs used to measure fair value.** The Board believes that there are qualitative differences among inputs used to measure fair value. These qualitative differences suggest that inputs should be organized into three levels. This Preliminary Views provides for different valuation techniques; however, the relative reliability of those techniques, in the Board's view, depends on the inputs to those techniques.

35. The fair value hierarchy would reflect the Board's view that the preferred inputs and the highest priority should be given to unadjusted market prices in active markets for identical assets or liabilities (**Level 1 inputs**); the next highest priority should be given to quoted prices for similar assets or liabilities or market-corroborated **observable inputs (Level 2 inputs)**; and the lowest priority should be given to **unobservable inputs (Level 3 inputs)**. A government would first consider Level 1 inputs, then Level 2 inputs if Level 1 inputs are not available, and finally Level 3 inputs if both Level 1 and Level 2 inputs are not available.

### **Level 1 Inputs**

36. Inputs within Level 1 of the fair value hierarchy would be unadjusted quoted prices in active markets for identical assets or liabilities. Quoted prices in active markets generally is the most relevant and reliable evidence of fair value and would be used to measure fair value whenever available. The Board's research indicates that quoted prices in active markets are readily attainable and verifiable for many investments. These prices also are understood by financial statement users. The Board also believes that prices should come from markets that are accessible by governments.

### **Level 2 Inputs**

37. Level 2 inputs of the fair value hierarchy would include inputs that are directly observable for the asset or liability (including quoted prices for similar assets or liabilities), as well as inputs that are not directly observable for the asset or liability. These inputs are derived principally from or corroborated by observable market data through correlation or by other means (**market-corroborated inputs**). The concept of market-corroborated inputs would be intended to incorporate observable market data (such as interest rates and yield curves that are observable at commonly quoted intervals) based on an assessment of factors relevant to the asset or liability. The Board concluded that market-corroborated inputs are observable inputs and that fair value measurements using market-corroborated inputs (Level 2) should be distinguished from fair value measurements using unobservable inputs (Level 3).

### Level 3 Inputs

38. Level 3 inputs would be unobservable inputs for an asset or a liability. Unobservable inputs would be used only when Level 1 and Level 2 inputs are not available. Although a government may begin with its own data, those data would be adjusted if market participants would do so. Level 3 inputs would include adjustments for risk when market participants would make such adjustments. Governments would develop unobservable inputs using the best available information. For example, a government holds a commercial mortgage-backed security as an investment. In determining the security's fair value, assumptions are made by the government regarding prepayment rates, probability of defaults, and loss severity. Because these assumptions are internally generated and cannot be observed in the market, the assumptions would be classified as Level 3 inputs.

### Using Quoted Prices Provided by Third Parties

39. The Board is aware that some governments use pricing services or brokers to obtain fair value measurements. The Board believes that quoted prices provided by third parties, such as pricing services or brokers, should be acceptable ways to measure fair value, as long as the government has determined that those prices have been developed in accordance with the guidance in this Preliminary Views. The same considerations of market volume and orderly transactions would apply, and the government should understand the inputs used by the third parties in developing the quotes. The Board believes this provision would assist governments in making their fair value measurements in a more cost-effective manner.

### Measurement of Nonfinancial Assets

#### Highest and Best Use

40. **It is the Board's preliminary view that a fair value measurement of a nonfinancial asset should consider the highest and best use of the asset.** Highest and best use would be a valuation concept used to value many nonfinancial assets, such as real estate. Highest and best use refers to a market participant's ability to generate economic benefits by using the asset according to its highest and best use or by selling it to another market participant who would use the asset according to its highest and best use. The notion would take into account uses that are physically possible, legally permissible, and financially feasible.

41. The Board observes that some governments are in a unique position to affect highest and best use through their ability to change what is legally permissible. For example, a government may hold industrial land that could be rezoned for multi-family housing. The presumption of this preliminary view, however, is that a government's use of nonfinancial property as it is currently zoned is its highest and best use.

42. The highest and best use of a nonfinancial asset may provide maximum value to market participants either as a stand-alone asset, in combination with other assets as a

group, or in combination with other assets and liabilities. The Board believes that the determination of the price a government would receive for the asset should assume that the asset would be used in combination with other assets and liabilities if that is its highest and best use. The valuation approach used to measure a nonfinancial asset could differ depending on whether its highest and best use is based on the asset as a stand-alone asset or in combination with other assets and liabilities.

## **Measuring the Fair Value of Investments in Certain Entities That Calculate Net Asset Value per Share**

43. **It is the Board’s preliminary view that governments should be permitted to calculate the fair value of investments that do not have a readily determinable fair value using a practical expedient.** That is, the fair value of such investments would be measured according to the **net asset value per share** (or its equivalent, such as member units or ownership interest in partners’ capital). Without a **readily determinable fair value**, the fair value of these types of investments may be very difficult to measure. The absence of a readily determinable fair value means that prices are not available from a securities exchange, the over-the-counter market, or a mutual fund sponsor. Ownership interests in these entities are often not bought and sold in a marketplace but, rather, transactions occur through contributions and distributions directly with the investment manager. Therefore, market-based information regarding their value may not exist.

44. The practical expedient acknowledges current practice but is not without flaws. The Board believes that classification within the fair value hierarchy for investments in certain entities that calculate net asset value per share (or its equivalent) requires judgment. Because of the use of the practical expedient to determine fair value, it would be difficult to determine the inputs used. The Board believes that a Level 2 classification should be used if it is possible to redeem the investment at the net asset value at the measurement date. If a government may never be able to redeem the investment at its net asset value, a Level 3 classification would be used. If the government may be able to redeem the investment at net asset value at a future date, the hierarchy classification would be left to professional judgment based on the nature of the restriction and length of time until the investment can be redeemed.

## **Measurement of Liabilities**

45. **It is the Board’s preliminary view that a fair value measurement of a liability assumes that the liability is transferred to another party at the measurement date.** The other party then would be required to fulfill the obligation; the liability would not be settled with the counterparty or be otherwise extinguished at that time. Because fair value would be defined as a market-based price, the Board believes that the price paid to transfer the liability to a market participant would be a better measure of fair value than the amount needed to settle with the counterparty.

## **Liabilities Held by Other Parties as Assets**

46. If a quoted price for the transfer of an identical or a similar liability is not available but the identical item is held by another party as an asset, the Board believes it would be appropriate for a government to measure the fair value of its liability based on the fair value of the other party's asset. The government would first consider quoted market prices, then other observable inputs if a quoted price is not available, and finally unobservable inputs if observable inputs are not available.

## **Nonperformance Risk**

47. The Board believes that the fair value of a liability should reflect **nonperformance risk**, including, but not limited to, a government's own credit risk. A market participant may place a premium or discount on the price paid to a transferor of a liability based on those risk factors.

## **Restrictions Preventing the Transfer of a Liability**

48. The Board believes that the measurement of the fair value of a liability should not consider any restrictions that would prevent the liability from being transferred. The Board believes that such restrictions should implicitly or explicitly be included in the other inputs used in the measurement and should not require a separate consideration.

## **CHAPTER 3—APPLICATION OF FAIR VALUE TO ASSETS AND LIABILITIES**

1. This chapter presents the Board’s preliminary views on which assets and liabilities should be measured at fair value. A revised definition of an investment and examples are presented. The application of fair value to most investments is discussed, as are exceptions.

### **Definition of an Investment**

2. **It is the Board’s preliminary view that an investment should be defined as a security or other asset that a government holds primarily for the purpose of income or profit, and its present service capacity is based solely on its ability to generate cash, to be sold to generate cash, or to procure services for the citizenry.**

3. A government acquires an investment asset primarily for future income or profit. Evidence that a government holds an asset for income or profit may be found in the fund that reports the asset (for example, a permanent fund).

4. All assets are resources with present service capacity that a government presently controls. Service capacity refers to how that asset can be used to fulfill a government’s mission to provide services. Some financial instruments—that would not be investments—generate cash, but holding those financial instruments is in itself a service that the government provides. An investment asset’s service capacity also may be achieved without generating cash, such as when an investment asset is surrendered to procure services directly in an exchange transaction.

### **Examples of the Application of the Definition of an Investment**

5. The following are examples of assets that a government might hold, evaluated against the definition of an investment.

6. A public university holds student loan receivables. The loans were made as part of a governmental program to encourage higher education. The service capacity of the loans is to provide a service that allows students to obtain an education. Because the service capacity is not based solely on the loan’s ability to generate cash, these loans would not meet the definition of an investment.

7. A housing authority holds mortgage loan receivables. These loans were made as part of a governmental program to encourage home ownership. The service capacity of the loans is to provide a service that allows residents to purchase a home. Because the service capacity is not based solely on the loan’s ability to generate cash, these loans would not meet the definition of an investment.

8. A city owns life insurance policies on certain key employees. If the insured individuals die while still employed, a portion of the proceeds is paid to the individual’s beneficiary and a portion is paid to the city. The city’s purpose for holding the policies is

for indemnification if the employee dies and to provide a benefit to the employee. Because the service capacity is not based solely on the ability to generate cash, these policies would not meet the definition of an investment.

9. A pension plan owns a life settlement contract (see paragraphs 17 and 18 of this chapter). Because the plan (investor) does not have an insurable interest, the contract is held primarily for the purpose of profit (the proceeds received over the consideration paid), and the present service capacity is solely the contract's ability to generate cash for the plan. Therefore, this contract would meet the definition of an investment.

10. A state owns royalty interests in oil and gas properties. It holds these interests in order to generate income for providing funding to schools within the state. It does not own the real property associated with the oil and gas rights. There is no governmental program or service associated with the ownership of the interests. Because the primary purpose of holding the royalty interests is for the purpose of income and the service capacity is based solely on the ability to generate cash, these assets would meet the definition of an investment.

11. A state government owns land and timber resources in an undeveloped part of the state. The state holds the resources in order to preserve the natural environment. The state occasionally enters into contracts for companies to cut and sell the timber, for which the state receives a fee. Because the land and timber resources also are held for preservation and not primarily for the purpose of income or profit, and their service capacity is not based solely on the ability to generate cash, the land and timber resources would not meet the definition of an investment.

12. A state government owns land and timber resources in an undeveloped part of the state. The state holds the land and manages it on a basis that benefits multiple uses: recreation, heritage, and timber sales. To finance the state's obligation to provide basic education, timber contracts are routinely entered into for the purpose of cutting and selling the timber for a fee. Because the land is not held solely for its ability to generate cash, to be sold to generate cash, or to procure services for the citizenry, the land would not meet the definition of an investment.

13. A government holds assets in reserve to satisfy bond covenants. The purpose of such reserves is to set aside resources that can be used to pay creditors. Such assets can be sold to generate cash to make bond payments, if needed. The government holds the reserves in securities to earn a greater return than would be obtained on a cash account. Such bond reserve assets meet the criterion that "service capacity is based solely on its ability to generate cash," and as the assets are held for income, they would meet the definition of an investment.

## **Investments to Be Measured at Fair Value**

14. **It is the Board's preliminary view that investments generally should be measured at fair value, with the exceptions described in paragraph 19 of this chapter.** Any asset that meets the definition of an investment and is not specifically

excluded in paragraph 19 would be measured at fair value. The Board believes this would bring consistency to the reporting of items that are held for investment.

15. The Board believes that fair value measurements should be the primary basis for measuring investment assets. Investments that have significant fair value changes would report those changes as gains and losses on the basis that those gains and losses represent increases and decreases, respectively, of a government's ability to finance its activities and of the financial resources available to finance claims on a government's resources. In the Board's view, amortized cost measurements have the potential to mislead financial statement users in that unrealized losses could become realized losses if a government chooses or is forced to sell debt investments prior to their scheduled maturities.

16. The preliminary views in this document would specifically apply to measurement of investments as addressed in the following Statements:

- a. Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, paragraphs 40–47, as amended
- b. Statement 25, paragraph 24, as amended
- c. Statement 31, paragraphs 2–20, as amended
- d. Statement 32, paragraphs 5 and 6, as amended
- e. Statement No. 40, *Deposit and Investment Risk Disclosures*, paragraphs 2–17, as amended
- f. Statement 43, paragraph 22, as amended
- g. Statement 52, paragraphs 4 and 5
- h. Statement 53, paragraph 20, as amended
- i. Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, paragraphs 424–427, as amended, to the extent they address mortgage loans, real estate holdings, and other assets that meet the definition of an investment
- j. Statement 62, paragraphs 431–451, as amended, to the extent they address assets arising out of lending activities that meet the definition of an investment
- k. Statement 62, paragraphs 452–475, to the extent they address assets arising from mortgage banking activities that meet the definition of an investment
- l. Statement 67, paragraph 18.

### **Life Settlement Contracts**

17. The Board believes that life settlement contracts should be measured at fair value. Life settlement contracts have the following characteristics:

- a. The investor does not have an insurable interest (an interest in the survival of the insured, which is required to support the issuance of an insurance policy).
- b. The investor provides consideration to the policy owner of an amount in excess of the current cash surrender value of the life insurance policy.
- c. The contract pays the face value of the life insurance policy to an investor when the insured dies.

18. The Board believes that there should be a distinction between, and different measurements for, a life insurance policy that is entered into to indemnify a loss and a life settlement contract that is entered into as an investment. The Board believes that an insurance policy that is acquired when there is no insurable interest would meet the definition of an investment asset. That is, the purpose of the instrument is solely to generate cash. Governments that hold life insurance policies that do not meet the definition of a life settlement contract would measure such policies at cash surrender value.

### **Investments Excluded from Measurement at Fair Value**

19. The Board believes that the following investments should be excluded from measurement at fair value. They would continue to be measured in accordance with existing literature:

- a. Money market investments and participating interest-earning investment contracts that have a remaining maturity at time of purchase of one year or less, reported by governments other than external investment pools
- b. Investments in 2a7-like external investment pools
- c. Investments in life insurance other than investments in life settlement contracts (see paragraphs 17 and 18 of this chapter)
- d. Investments in common stock that meet the criteria for applying the equity method of accounting in paragraphs 205–208, as amended, of Statement 62, subject to exclusionary provisions in paragraph 202 of Statement 62 (see paragraphs 20–22 of this chapter)
- e. Nonparticipating interest earning investment contracts
- f. Unallocated insurance contracts
- g. Synthetic guaranteed investment contracts that are fully benefit responsive.

### **Use of the Equity and Cost Methods**

20. The Board believes that investments in certain entities that calculate net asset value per share should not be eligible for the equity method of accounting. Under the equity method of accounting, shareholders report their pro rata portion of an investee's equity and income, regardless of whether that income has been distributed to shareholders. Also, common stock investments held by endowments would not be eligible for the equity method. These types of investments would be measured at their fair values and added to the exclusionary provisions of paragraph 202 of Statement 62.

21. The Board believes that if a government owns common stock that meets the criteria for the equity method but that ownership does not meet the proposed definition of an investment, the equity method should continue to be applied.

22. For stocks that do not have readily determinable fair values, the Board believes that the cost method should be eliminated from GASB guidance for investments in common stock. Investments in common stock would be measured either at fair value or under the equity method.

## Changes to Existing Fair Value Guidance

### Acquisition Value

23. It is the Board’s preliminary view that fair value should be replaced by acquisition value for the following assets:

- a. Capital assets received in a nonexchange transaction (GASB Codification, 1400.155)
- b. Donated capital assets (Statement No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, paragraph 18, as amended)
- c. Donated works of art, historical treasures, and similar assets (Statement 34, paragraph 27)
- d. Capital assets received in a service concession arrangement (Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*, paragraph 62)
- e. Nonmonetary assets acquired in an exchange when the value of the asset received is used to measure the cost of the asset acquired (Statement 62, paragraph 274).

24. As discussed in Chapter 2, the Board believes that fair value is an exit price. Therefore, the Board believes it is more appropriate for these assets, valued upon acquisition rather than disposition, to be valued at an entry price. The Board believes **acquisition value** is a market-based entry price. An entry price is assumed to be based on an orderly transaction entered into on the acquisition date. Acquisition value represents the price that would be paid for acquiring similar assets, having similar service capacity, or discharging the liabilities assumed as of the acquisition date.

### Transaction Costs

25. As discussed in Chapter 2, paragraphs 21 and 22, the Board believes that fair value measurements should be made without adjustment for transaction costs. Current guidance for reporting investments by defined benefit pension and other postemployment benefit plans indicates that the fair value of those investments “should reflect brokerage commissions and other costs normally incurred in a sale, if determinable” (Statement 25, paragraph 24, footnote 7; Statement 43, paragraph 18, footnote 7; and Statement 67, paragraph 18, footnote 7). It is the Board’s preliminary view that this guidance should be revised to conform to the fair value definition.

26. The Board believes that fair value measurements should be made consistently, regardless of the type of entity that is making them. Because the Board’s preliminary view is that a fair value measurement should not be adjusted for transaction costs such as brokerage commissions, the Board also believes that existing guidance for defined benefit pension and other postemployment benefit plans should be revised accordingly.

## CHAPTER 4—DISCLOSURES

1. This chapter presents the Board’s preliminary views on disclosure requirements related to fair value measurement and application.
2. In Concepts Statement No. 3, *Communication Methods in General Purpose External Financial Reports That Contain Basic Financial Statements*, the Board indicates that notes to the financial statements are “integral to financial statements and are essential to a user’s understanding of financial position or inflows and outflows of resources” (paragraph 35). Notes to the financial statements provide descriptions of the accounting policies underlying amounts recognized in the financial statements and more details about or explanations of those amounts.
3. **It is the Board’s preliminary view that, when fair value measurements are used in determining the amounts recognized in the financial statements, a disclosure should be made regarding how those amounts are determined.** The Board believes that such disclosures would provide users with essential information regarding the reliability and sensitivity of the amounts recognized, which may vary depending on the type of asset or liability. The Board notes that the current literature already requires significant disclosures. For example, Statement 31 requires disclosure of “the methods and significant assumptions used to estimate the fair value of investments, if that fair value is based on other than quoted market prices” (paragraph 15a). Also, Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*, and Statement 40 require disclosure of custodial credit risk, credit risk, and interest rate risk.
4. Illustrative examples of the disclosure requirements are included in Appendix B.

### Level of Detail

5. **It is the Board’s preliminary view that disclosures should be organized by type or class of asset or liability.** The following paragraph would replace the guidance currently required in Statement 40 on the level of detail. The proposed provisions would apply to any assets or liabilities measured at fair value and not just to investments.
6. The level of detail, how much emphasis to place on each disclosure requirement, and how much disaggregation to undertake would be determined based on considerations, including the following:
  - a. *The nature, characteristics, and risks of the asset or liability.* For example, U.S. treasury notes would be disaggregated from U.S. treasury strips.
  - b. *The level of the fair value hierarchy within which the fair value measurement is categorized.* The greater degree of uncertainty and subjectivity suggests that the number of types and classes may need to be greater for fair value measurements categorized within Level 3 of the fair value hierarchy.

- c. *Whether this Preliminary Views or a Statement specifies a type or class for an asset or a liability.* For example, Statement 53 requires derivative instrument disclosures for hedging derivative instruments and investment derivative instruments (paragraph 69).
- d. *The relative significance of assets and liabilities measured at fair value compared to total assets and liabilities.*
- e. *Whether separately issued financial statements are available.* For example, a state government may consider reduced disclosures of Level 3 inputs of hedging interest rate swaps if the state's housing finance authority (a discretely presented component unit) already presents those detailed disclosures in its separately issued financial statements.
- f. *Individual assets and liabilities presented in the statement of financial position.*<sup>2</sup> A class or type of assets and liabilities will often require greater disaggregation than the line items presented in the statement of financial position.

7. The Board's preliminary view is that specific criteria for level of detail are impractical due to the diversity of assets and liabilities that may be measured at fair value and the facts and circumstances unique to each government. A government's specific circumstances would dictate the level of disaggregation and amount of detail to disclose. The Board believes this is best left to professional judgment.

## **Specific Disclosures**

8. The Board believes that disclosures should be made for recurring and nonrecurring fair value measurements. Recurring fair value measurements are measurements required in the statement of financial position at the end of each reporting period. Nonrecurring fair value measurements would be required in the statement of financial position only in particular circumstances, such as impaired capital assets that will no longer be used by the government and are measured at the lower of carrying value or fair value. The Board believes that information regarding fair value measurement is essential information, even if that measurement is made only once. However, the Board believes a discussion of the sensitivity to unobservable inputs of nonrecurring measurements would not be appropriate because those amounts would not be expected to be subsequently remeasured with those inputs.

**9. It is the Board's preliminary view that governments should disclose the following information in the notes to the financial statements for each class or type of asset and liability measured at fair value in the statement of financial position.**

- a. For recurring and nonrecurring fair value measurements:
  - (1) The fair value measurement at the end of the reporting period
  - (2) The level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (Level 1, 2, or 3), and the valuation techniques and inputs used to develop those measurements

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<sup>2</sup>The term *statement of financial position* includes the statement of net position and governmental fund balance sheets.

- (3) A description of the valuation techniques and the inputs used in the fair value measurement. If there has been a change in valuation technique that has a significant impact on the result (for example, a change from a technique using a [market approach](#) to a technique using an [income approach](#) or the use of an additional valuation technique), the government would disclose that change and the reason(s) for making it.
- b. For nonrecurring fair value measurements, the reasons for the measurement.

All disclosures discussed in this Preliminary Views could be in either tabular or narrative format. The Board believes that information regarding the level of inputs for each class of asset or liability would greatly benefit financial statement users. Requiring a narrative or table that communicates input levels would provide information as to the sources of inputs and the implied reliability of fair value measurements.

10. For fair value measurements categorized within Level 3 of the fair value hierarchy, a government would disclose quantitative information in the notes to the financial statements about the significant unobservable inputs used in the fair value measurement. If a fair value is developed by a pricing service, there would be no requirement to disclose significant assumptions if the pricing service considers those assumptions to be proprietary and, after a government makes a reasonable effort, the pricing service declines to make that information available. This fact, however, would be disclosed.

**11. It is the Board's preliminary view that governments should disclose a narrative description of the sensitivity of fair value measurements to changes in unobservable inputs in the notes to the financial statements about recurring fair value measurements categorized in Level 3 of the fair value hierarchy.** This disclosure would be made when a change in those inputs might result in a significantly higher or lower fair value measurement, after considering the following:

- a. Interrelationships between those inputs and other unobservable inputs used in the fair value measurement
- b. A description of those interrelationships and of how they might magnify or mitigate the effect of changes in the unobservable inputs on the fair value measurement.

To comply with the above disclosure requirement, the narrative description of the sensitivity to changes in unobservable inputs would include, at a minimum, the unobservable inputs disclosed when complying with paragraph 9a(2) of this chapter.

12. The Board believes that the sensitivity of fair value measurements to changes in unobservable inputs is essential information because of the inherent nature of unobservable inputs. The Board believes that the above disclosures described in paragraph 11 are similar to Statement 40's required disclosures for debt investments that are highly sensitive to interest rate changes. In many cases, the Board believes that Statement 40's risk disclosure also would satisfy this Level 3 narrative disclosure requirement.

## **Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share**

13. Some governmental entities place a portion of their assets into alternative investments. Many of these investments would be measured using the “practical expedient” discussed in Chapter 2, paragraphs 43 and 44. **It is the Board’s preliminary view that, due to the uncertainty and subjectivity involved in measurements of these investments, there should be disclosures that address them in further detail.**

14. The following disclosures would apply to investments in entities that calculate a net asset value per share or its equivalent (regardless of whether the practical expedient has been applied) and are measured at fair value on a recurring or nonrecurring basis during the period. A government would disclose information that helps users of its financial statements to understand the nature and risks of the investments and whether the investments are likely to be sold at amounts different from net asset value per share (or its equivalent, such as member units or an ownership interest in partners’ capital to which a proportionate share of net assets is attributed).

- a. To the extent applicable, a government would disclose the following information for each type of investment:
  - (1) The fair value measurement (which may be determined by applying the “practical expedient” in Chapter 2, paragraph 43) of the investments in the class at the reporting date and a description of the significant investment strategies of the investee(s) in the class
  - (2) The amount of the government’s unfunded commitments related to investments in the class
  - (3) A general description of the terms and conditions upon which the government may redeem investments in the type (for example, quarterly redemption with 60-days’ notice).
- b. If there are circumstances in which an otherwise redeemable investment in the type (or a portion thereof) might not be redeemable (for example, investments subject to a lockup or gate), the government would disclose those circumstances. Also, for those otherwise redeemable investments that are restricted from redemption as of the government’s measurement date, the government would disclose its estimate of when the restriction from redemption might lapse. If an estimate cannot be made, the government would disclose that fact and how long the restriction has been in effect.
- c. If there is any other significant restriction on the ability to sell investments in the class at the measurement date, the government would disclose that restriction.
- d. If a government determines that it is likely that it will sell an investment(s) for an amount different from net asset value per share (or its equivalent), the government would disclose the total fair value of all such investments and any remaining actions required to complete the sale.
- e. If a government is unable to identify individual investments to be sold, that circumstance would continue to meet the criteria for the practical expedient. For example, a government decides to sell 20 percent of its investments in private equity funds but the individual investments to be sold have not been identified. In that case,

the government would disclose its plans to sell and any remaining actions required to complete the sale(s).

- f. If investments can never be redeemed with the investees, but the government receives distributions through the liquidation of the underlying assets of the investees, the government would disclose, for each type of investment, its estimate of the period of time over which the underlying assets are expected to be liquidated by the investees.

15. The Board believes that these additional disclosures would provide more information about the estimated fair values in a manner that fits the nature of the investments. Additionally, the Board believes that because fair value is an exit price, these additional disclosures would be useful when it is likely that the investment could be sold at an amount different than the net asset value.

## **Appendix A**

### **GLOSSARY**

#### **Active Market**

A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.

#### **Acquisition Value**

The price that would be paid to acquire an asset with equivalent service potential in an orderly market transaction at the acquisition date, or the amount at which a liability could be liquidated with the counterparty at the acquisition date.

#### **Cost Approach**

A valuation approach that reflects the amount that would be required currently to replace the service capacity of an asset.

#### **Credit Risk**

The risk that a counterparty will not fulfill its obligations.

#### **Entry Price**

The price that would be paid to acquire an asset or received to assume a liability.

#### **Exit Price**

The price that would be received to sell an asset or paid to transfer a liability.

#### **Fair Value**

The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

#### **Financial Instrument**

Cash, evidence of an ownership interest in an entity, or a contract that both:

1. Imposes on one entity a contractual obligation to deliver cash or another financial instrument to a second entity or exchange other financial instruments on potentially unfavorable terms with the second entity
2. Conveys to that second entity a contractual right to receive cash or another financial instrument from the first entity or to exchange other financial instruments on potentially favorable terms with the first entity.

#### **Highest and Best Use**

The use of a nonfinancial asset by market participants that would maximize the value of the asset or the group of assets and liabilities within which the asset would be used.

**Income Approach**

A valuation approach that converts future amounts (for example, cash flows or income and expenses) to a single current (that is, discounted) amount.

**Inputs**

The assumptions that market participants would use when pricing the asset or liability, including assumptions about risk, such as the following:

1. The risk inherent in a particular valuation technique used to measure fair value (such as a pricing model)
2. The risk inherent in the inputs to the valuation technique.

Inputs may be observable or unobservable.

**Investment**

A security or other asset that a government holds primarily for the purpose of income or profit, and its present service capacity is based solely on its ability to generate cash, to be sold to generate cash, or to procure services for the citizenry.

**Level 1 Inputs**

Quoted prices (unadjusted) in active markets for identical assets or liabilities that the government can access at the measurement date.

**Level 2 Inputs**

Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

**Level 3 Inputs**

Unobservable inputs for an asset or a liability.

**Market Approach**

A valuation approach that uses prices and other relevant information generated by market transactions involving identical or comparable (that is, similar) assets, liabilities, or a group of assets and liabilities, such as a business.

**Market Participants**

Buyers and sellers in the principal (or most advantageous) market for an asset or a liability that have all of the following characteristics:

1. They are independent of each other, that is, they are not related parties, although the price in a related-party transaction may be used as an input to a fair value measurement if the government has evidence that the transaction was entered into at market terms
2. They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary

3. They are able to enter into a transaction for the asset or liability
4. They are willing to enter into a transaction for the asset or liability; that is, they are motivated but not forced or otherwise compelled to do so.

**Market-Corroborated Inputs**

Inputs that are derived principally from or corroborated by observable market data by correlation or other means.

**Matrix Pricing**

A valuation technique used to value securities based on the securities' relationship to benchmark quoted prices.

**Most Advantageous Market**

The market that maximizes the amount that would be received to sell an asset or minimizes the amount that would be paid to transfer a liability, after taking into consideration transaction and transportation costs.

**Multiperiod Excess Earnings Method**

A valuation technique based on prospective financial information associated with a collection of assets, then reduced for the contributions of supporting assets, with the residual amount being the excess earnings associated with the asset being valued.

**Net Asset Value per Share**

The amount of net assets attributable to each share of capital stock (other than senior equity securities; that is, preferred stock) outstanding at the close of the period. It excludes the effects of assuming conversion of outstanding convertible securities, whether or not their conversion would have a diluting effect.

**Nonperformance Risk**

The risk that an entity will not fulfill an obligation. Nonperformance risk includes, but may not be limited to, a government's own credit risk.

**Observable Inputs**

Inputs that are developed using market data, such as publicly available information about actual events or transactions, and that reflect the assumptions that market participants would use when pricing the asset or liability.

**Option Pricing Model**

A valuation technique used to value an option contract that is based on the critical terms of the contract and implied volatility.

**Orderly Transaction**

A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).

**Present Value**

The worth today of a future payment or series of payments discounted at a specified interest rate.

**Principal Market**

The market with the greatest volume and level of activity for an asset or a liability.

**Readily Determinable Fair Value**

An equity security has a readily determinable fair value if it meets any of the following conditions:

1. The fair value of an equity security is readily determinable if sales prices or bid-and-asked quotations are currently available on a securities exchange registered with the U.S. Securities and Exchange Commission or in the over-the-counter market, provided that those prices or quotations for the over-the-counter market are publicly reported by the National Association of Securities Dealers Automated Quotations systems or by Pink Sheets LLC. Restricted stock meets that definition if the restriction terminates within one year.
2. The fair value of an equity security traded only in a foreign market is readily determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to above.
3. The fair value of an investment in a mutual fund is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions.

**Relief from Royalty Method**

A valuation technique based on discounted cash flows of royalty payments that would be required to use an asset if the government did not own it.

**Transaction Costs**

The costs to sell an asset or transfer a liability in the principal (or most advantageous) market for the asset or liability that are directly attributable to the disposal of the asset or the transfer of the liability and meet both of the following criteria:

1. They result directly from and are essential to that transaction.
2. They would not have been incurred by the entity had the decision to sell the asset or transfer the liability not been made.

**Unit of Account**

The level at which an asset or a liability is aggregated or disaggregated for recognition purposes.

**Unobservable Inputs**

Inputs for which market data are not available and that are developed using the best information available about the assumptions that market participants would use when pricing the asset or liability.

**Valuation Approach**

The methodology used to determine or estimate the value of an asset or liability.

**Valuation Technique**

A specific method or combination of methods used to determine or estimate the value of an asset or liability.

## Appendix B

### ILLUSTRATIVE DISCLOSURES

1. The facts assumed in these examples are illustrative only and are not intended to modify or limit this Preliminary Views or to indicate the Board's endorsement of the policies or practices shown. Application of this Preliminary Views may require assessment of facts and circumstances other than those illustrated here. Existing standards may require disclosures in addition to those illustrated. In some instances, amounts that may be considered immaterial are used to illustrate specific requirements or alternatives. No inferences about determining materiality should be drawn from these illustrations.

#### **Illustration 1—General Purpose Government**

##### *Facts and Assumptions*

The General City holds investments that are measured at fair value on a recurring basis. Because investing is not a core part of the City's mission, the City determines that the disclosures related to these investments only need to be disaggregated by major type. As of the end of the reporting period, the City held \$45 million of U.S. Treasury securities, priced using quoted market prices (Level 1 inputs). The City also held \$12 million in corporate bonds, priced using a matrix pricing model (Level 2 inputs). The City chooses a narrative format for disclosing the levels within the fair value hierarchy.

##### *Illustrative Disclosure*

The City categorizes its fair value measurements within the fair value hierarchy established by generally accepted accounting principles. The hierarchy is based on the valuation inputs used to measure the fair value of the asset. Level 1 inputs are quoted prices in active markets for identical assets; Level 2 inputs are significant other observable inputs; Level 3 inputs are significant unobservable inputs.

The City has the following recurring fair value measurements as of June 30, 20X1:

- U.S. Treasury securities of \$45 million are valued using quoted prices in an active market for identical assets (Level 1 inputs)
- Corporate bonds of \$12 million are valued using a matrix pricing model (Level 2 inputs).

#### **Illustration 2—Defined Benefit Pension Plan**

##### *Facts and Assumptions*

The Retiree Pension Defined Benefit Plan holds significant amounts of investments that are measured at fair value on a recurring basis. Because investing is a key part of the Plan's activities, the Plan shows greater disaggregation in its disclosures. The Plan has chosen a tabular format for disclosing the levels within the fair value hierarchy.

### ***Illustrative Disclosure***

The Plan categorizes its fair value measurements within the fair value hierarchy established by generally accepted accounting principles. The Plan has the following recurring fair value measurements as of December 31, 20X1:

	<b>Fair Value Measurements Using</b>			
	<b>12/31/X1</b>	<b>Quoted Prices in Active Markets for Identical Assets (Level 1)</b>	<b>Significant Other Observable Inputs (Level 2)</b>	<b>Significant Unobservable Inputs (Level 3)</b>
<b>Recurring fair value measurements</b>				
Debt securities				
U.S. Treasury securities	\$ 85	\$ 85	\$ –	\$ –
Commercial mortgage-backed securities	50	–	–	50
Collateralized debt obligations	35	–	–	35
Residential mortgage-backed securities	149	–	24	125
Corporate bonds	93	9	84	–
Total debt securities	<u>412</u>	<u>94</u>	<u>108</u>	<u>210</u>
Equity securities				
Financial services industry	150	150	–	–
Healthcare industry	110	110	–	–
Other	15	15	–	–
Total equity securities	<u>275</u>	<u>275</u>	<u>–</u>	<u>–</u>
Total securities	<u>687</u>	<u>369</u>	<u>108</u>	<u>210</u>
Hedge fund investments *				
Equity long/short	55	–	55	–
Event-driven hedge funds	45	–	45	–
Global opportunities	35	–	–	35
Multi-strategy hedge funds	40	–	40	–
Real estate funds	47	–	–	47
Private equity funds—international	43	–	43	–
Total hedge fund investments	<u>265</u>	<u>–</u>	<u>183</u>	<u>82</u>
Other investments				
Direct venture capital: healthcare	53	–	–	53
Direct venture capital: energy	32	–	–	32
Total other investments	<u>85</u>	<u>–</u>	<u>–</u>	<u>85</u>
Derivative instruments				
Interest rate swaps	57	–	57	–
Foreign exchange contracts	43	–	43	–
Total derivatives	<u>100</u>	<u>–</u>	<u>100</u>	<u>–</u>
Total recurring fair value measurements	<u>\$ 1,137</u>	<u>\$ 369</u>	<u>\$ 391</u>	<u>\$ 377</u>

\* Discussion of inputs for investments in hedge funds is presented in the table titled Fair Value Measurements of Investments in Certain Entities That Calculate Net Asset Value per Share.

Debt and equity securities classified in Level 1 of the fair value hierarchy are valued using prices quoted in active markets for those securities. Debt securities classified in Level 2 of the fair value hierarchy are valued using a matrix pricing technique. Matrix pricing is used to value securities based on the securities' relationship to benchmark quoted prices. Derivative instruments classified in Level 2 of the fair value hierarchy are valued using a market approach that considers benchmark interest rates and foreign exchange rates. The valuation method for hedge fund investments is either net asset value as a practical expedient for fair value, or a value estimated through recent observable transaction information for similar investments, as described for each class below.

Securities classified in Level 3 of the fair value hierarchy are valued using a discounted cash flow, consensus pricing, or market comparable companies technique, as specified in the following table. The significant unobservable inputs used are shown in the following table. Significant increases (decreases) in any of those inputs in isolation would result in a significantly lower (higher) fair value measurement. For discounted cash flow methods, generally a change in the assumption used for the probability of default is accompanied by a directionally similar change in the assumption used for the loss severity and a directionally opposite change in the assumption used for prepayment rates.

For instruments backed by mortgage assets, commercial real estate assets, and debt securities, a significant deterioration in credit quality or a significant increase in market yields, default rates, or loss severities may likely result in a significantly lower fair value for long positions. Short positions would be impacted in a directionally opposite way. The impact of changes in the timing of prepayments would depend on the maturity date of the instrument.

**Quantitative Information about Level 3 Fair Value Measurements (Excluding Investments that Calculate Net Asset Value)**

	Fair Value at 12/31/X1 (\$ in Millions)	Effect on Investment Income for the Year Ended 12/31/X1 (\$ in Millions)	Valuation Technique(s)	Unobservable Input	Range (Weighted Average)
Commercial mortgage-backed securities	50	2.5	Discounted cash flow	Constant prepayment rate	3.0% – 5% (4.1%)
				Probability of default	2% – 25% (5%)
				Loss severity	10% – 50% (20%)
Collateralized debt obligations	35	1.3	Consensus pricing	Offered quotes	20 – 45
				Comparability adjustments	-10% – +15% (+5%)
Residential mortgage-backed securities	125	8.9	Discounted cash flow	Constant prepayment rate	3.5% – 5.5% (4.5%)
				Probability of default	5% – 50% (10%)
				Loss severity	40% – 100% (60%)
Direct venture capital investments: healthcare	30	1.2	Discounted cash flow	Weighted average cost of capital	7% – 16% (12.1%)
				Long-term revenue growth rate	2% – 5% (4.2%)
				Long-term pretax operating margin	3% – 20% (10.3%)
				Discount for lack of marketability <sup>(a)</sup>	5% – 20% (17%)
				Control premium <sup>(a)</sup>	10% – 30% (20%)
Direct venture capital investments: healthcare	23	2	Market comparable companies	EBITDA* multiple <sup>(b)</sup>	6.5 – 12 (9.5)
				Revenue multiple <sup>(b)</sup>	1.0 – 3.0 (2.0)
				Discount for lack of marketability <sup>(a)</sup>	5% – 20% (10%)
				Control premium <sup>(a)</sup>	10% – 20% (12%)
Direct venture capital investments: energy	18	1	Discounted cash flow	Weighted average cost of capital	8% – 12% (11.1%)
				Long-term revenue growth rate	3% – 5.5% (4.2%)
				Long-term pretax operating margin	7.5% – 13% (9.2%)
				Discount for lack of marketability <sup>(a)</sup>	5% – 20% (10%)
				Control premium <sup>(a)</sup>	10% – 20% (12%)
Direct venture capital investments: energy	14	1.2	Market comparable companies	EBITDA multiple <sup>(b)</sup>	6.5 – 12 (9.5)
				Revenue multiple <sup>(b)</sup>	1.0 – 3.0 (2.0)
				Discount for lack of marketability <sup>(a)</sup>	5% – 20% (10%)
				Control premium <sup>(a)</sup>	10% – 20% (12%)

\* EBITDA is defined as earnings before interest, taxes, depreciation, and amortization.

<sup>(a)</sup> Represents amounts used when the Plan has determined that market participants would take into account these premiums and discounts when pricing the investments.

<sup>(b)</sup> Represents amounts used when the Plan has determined that market participants would use such multiples when pricing the investments.

## Fair Value Measurements of Investments in Certain Entities That Calculate Net Asset Value per Share

	<u>Fair Value (in millions)</u>	<u>Unfunded Commitments</u>	<u>Redemption Frequency (if currently eligible)</u>	<u>Redemption Notice Period</u>
Equity long/short hedge funds <sup>(a)</sup>	\$ 55	\$ –	Quarterly	30 – 60 days
Event-driven hedge funds <sup>(b)</sup>	45	–	Quarterly, annually	30 – 60 days
Global opportunities hedge <sup>(c)</sup>	35	–	Quarterly	30 – 45 days
Multi-strategy hedge funds <sup>(d)</sup>	40	–	Quarterly	30 – 60 days
Real estate funds <sup>(e)</sup>	47	20		
Private equity funds—international <sup>(f)</sup>	<u>43</u>	<u>15</u>		
Total	<u>\$ 265</u>	<u>\$ 35</u>		

- a. This class includes investments in hedge funds that invest both long and short primarily in U.S. common stocks. Management of the hedge funds has the ability to shift investments from value to growth strategies, from small to large capitalization stocks, and from a net long position to a net short position. The fair values of the investments in this class have been estimated using the net asset value per share of the investments. Investments representing approximately 22 percent of the value of the investments in this class cannot be redeemed because the investments include restrictions that do not allow for redemption in the first 12 to 18 months after acquisition. The remaining restriction period for these investments ranged from three to seven months at December 31, 20X1.
- b. This class includes investments in hedge funds that invest in approximately 60 percent equities and 40 percent bonds to profit from economic, political, and government driven events. A majority of the investments are targeted at economic policy decisions. The fair values of the investments in this class have been estimated using the net asset value per share of the investments.
- c. This class includes investments in hedge funds that hold approximately 80 percent of the funds' investments in non-U.S. common stocks in the healthcare, energy, information technology, utilities, and telecommunications sectors and approximately 20 percent of the funds' investments in diversified currencies. The fair values of the investments in this class have been estimated using the net asset value per share of the investments. For one investment, valued at \$8.75 million, a gate has been imposed by the hedge fund manager and no redemptions are currently permitted. This redemption restriction has been in place for six months and the time at which the redemption restriction might lapse cannot be estimated.
- d. This class includes investments in hedge funds that pursue multiple strategies to diversify risks and reduce volatility. The hedge funds' composite portfolio for this class includes investments in approximately 50 percent U.S. common stocks, 30 percent global real estate projects, and 20 percent arbitrage investments. The fair values of the investments in this class have been estimated using the net asset value per share of the investments. Investments representing approximately 15 percent of the value of the investments in this class cannot be redeemed because the investments include restrictions that do not allow for redemption in the first year after acquisition. The remaining restriction period for these investments ranged from four to six months at December 31, 20X1.
- e. This class includes investments in several real estate funds that invest primarily in U.S. commercial real estate. The fair values of the investments in this class have been estimated using the net asset value of the Plan's ownership interest in partners' capital. These investments can never be redeemed with the funds. Distributions from each fund will be received as the underlying investments of the funds are liquidated. It is estimated that the underlying assets of the fund will be liquidated over the next 7 to 10 years. Twenty percent of the total investment in this class is planned to be sold. However, the individual investments that will be sold have not yet been determined. Because it is not probable that any individual investment will be sold, the fair value of each individual investment has been estimated using the net asset value of the Plan's ownership interest in partners' capital. Once it has been determined which investments will be sold and whether those investments will be sold individually or in a group, the investments will be sold in an auction process. The investee fund's management is required to approve the buyer before the sale of the investments can be completed.
- f. This class includes investments in several private equity funds that invest primarily in foreign technology companies. These investments can never be redeemed with the funds. Instead, the nature of the investments in this

class is that distributions are received through the liquidation of the underlying assets of the fund. If these investments were held, it is estimated that the underlying assets of the fund would be liquidated over five to eight years. However, as of December 31, 20X1, it is probable that all of the investments in this class will be sold at an amount different from the net asset value of the Plan's ownership interest in partners' capital. Therefore, the fair values of the investments in this class have been estimated using recent observable transaction information for similar investments and nonbinding bids received from potential buyers of the investments. As of December 31, 20X1, a buyer (or buyers) for these investments has not yet been identified. Once a buyer has been identified, the investee fund's management is required to approve the buyer before the sale of the investments can be completed.